

Rethinking Market Regulation: Policy Lessons from other Disciplines Conclusions

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ABSTRACT

Other disciplines increase our knowledge of when and how markets can be relied on to bring about optimal outcomes. They thereby make a significant contribution to the fine tuning of market regulation policies. Sometimes such fine tuning is in clear focused and well developed information strategies. For instance when limited consumer motivation and limited capacity to discern quality differences between competitors deem policies that simply increase the availability of information less effective; Or in the instance that increased transparency may lead to tacit collusion. Sometimes the fine tuning is in acknowledging that there is scope for increased reliance on implicit contracts or reputation mechanisms and in developing structures to foster such reliance. But most of all perhaps, the studies show that it is not only our understanding of to how to reach the social optimum, but also of what constitutes it, that may need to be regauged.

* The views expressed in this article do not necessarily reflect the view of the ministry

I. INTRODUCTION

The complexity of learning is not so much in the complicated nature of the things you learn, but in the difficulty of connecting them to the things you knew before. To us this seems to be the primary ‘problem’ of the relation of market regulation policy with economic science as well as with other sciences. As Erik Schokkaert points out in the introduction to this volume, economic science has made substantial progress in this area. However, have economic policymaking learned similar lessons? This question led the Dutch Ministry of Economic Affairs to invite academics from different disciplines to reflect on the implications of their research for market regulation. In this concluding article we will first give a brief description of transformations in regulatory policy and of their roots. Next we will review the main policy lessons that emerge from the different contributions.

II. TRENDS IN ECONOMIC POLICY MAKING

The increased reliance on individual responsibility and incentives has been a key trend in economic policy making over the last two decades. Both pillars that traditionally legitimise government intervention in markets (market failure and income distribution) have been reinterpreted accordingly.

Up until the 1970s, strong emphasis was placed on the role for governments in realising the welfare state and in economic policy. By bringing in elements of solidarity and cross subsidisation, as well as by providing collective arrangements, regulation aimed at reaching an income distribution that was socially preferred to the unregulated outcome. By making up for market failures that could not be overcome by private parties, like information asymmetries and external effects, and by creating scope for economies of scale, regulation provided a second-best solution to maximising the social surplus. To these ends, social insurance-arrangements were to a large part obligatory, provision of network-, healthcare and educational facilities was in public hands and market entry was often limited to qualified parties.

The scope for such interventions, however, has increasingly come under pressure. And for good reasons. By the end of the 70’s the disastrous budgetary situation in many European countries forced

governments to reduce their ambitions, at least those for which costs were high. This tendency was strengthened by increasing international competition, which reduced the possibilities for financing large-scale public expenditure through rises in taxation.

As of the end of the eighties, greater economic dynamism, the rise in both income and educational levels of European populations and the related rise in individualism and diversity of individual wants, made it harder to define a clear cut public interest and reduced the scope for one-size-fits-all regulation. The need for more choice seemed to gain importance relative to economies of scale, better education seemingly reduced the need to overcome information asymmetries by quality and price standards, and individualism limited the surplus value of collective agreements (see also Vijlbrief (2001)). This was reinforced by the rising disappointment among citizens about the quality of public service provision (poor school quality, waiting lists in health care etc.) and by the growing awareness of the distortions created by interventions themselves.

Taken together this led to a shifting perspective as to how the public interest should best be served. In short, in the last two decades both the room and the perceived need for interventions diminished. The pendulum of regulation thus swung from direct imperative intervention to allowing the, ever so diligent, invisible hand that was known from textbook descriptions of perfect markets, to do its work. By removing barriers to entry and by allowing consumers choice between providers of goods and services, regulators sought to create the conditions in which assertive consumers and competition would drive markets to socially optimal outcomes. In this framework information and transparency increasingly replaced regulation and control as disciplining devices. For (semi) public institutions too, incentives to both raise quality and reduce costs were strengthened. In fact, the focal point of market regulation changed from direct intervention to mimicking (perfect) market conditions.

III. LESSONS FROM OTHER DISCIPLINES

The papers presented in this issue are analytically rich and have interesting implications for the policy stance discussed above. We do not intend to summarise the full content of these articles, nor do we have the ambition to review the implications for the vast domain that market

regulation is about. For the sake of clarity we will focus on five lessons that we think economic policymakers could learn from the papers in this issue.

Lesson I

Large groups of consumers lack the capacity to deal with complicated information, and therefore do not react as economic textbooks suggest. Current approaches by governments to raise transparency, focus too much on the availability of information per se and too little on well-directed improvements of the capacity to handle information.

Information asymmetry constitutes a classic form of market failure. Sufficient information is a *conditio sine qua non* for creating a disciplining effect of consumer choice. The contributions to this issue suggest that it is not simply the *availability* of information that matters, but (also) the *capacity* of economic actors to deal with it. In fact, in complex markets it is frequently not the lack but the abundance of information that seems to hamper individual choice. Although information policies nowadays seem to slowly incorporate this idea (see for instance the website www.staiksterk.nl), there is still a strong focus on making information available per se (obligatory information tags on financial products, public information campaigns in the media, internet etc.). If capacity is the determining factor for translating information into behaviour, then perhaps guiding consumers in determining which information is relevant might be more helpful. Also, effectiveness might be raised by trying to define which groups might be most limited in their capacity, for instance elderly people, and directing assistance to these groups. Governments should more and more pick up a role as ‘decision consultant’ for groups unable to deal with available information or should reinforce market initiatives to act as an information broker. However, as such an active information broker’s role is no doubt costly, governments should be well aware that such a strategy will not prove net beneficial in every market. A more focused role in overcoming capacity limits would seem to be most valuable for markets which are characterised by i) high consumer involvement (see below) and ii) goods for which relevant decision criteria are manifold or performance only gets revealed over time (complex and experience goods).

Lesson II

Economic policy expects consumers to be highly motivated to switch between suppliers, and thereby discipline them. In reality this disciplinary effect of consumer behaviour can not always be expected to occur.

From the psychological approach we learn that motivation is a crucial determinant for the disciplinary effect of consumer behaviour to materialise. If, in the perception of consumers, quality differences are small, a rational strategy for them is to make little costs for collecting information about different products and providers. In other words, in such cases the motivation may be lacking to actively discipline suppliers. The question may now be raised if there is a role for government to raise transparency, or if possible, to try to influence motivation of consumers. This question is closely related to the one dealt with under Lesson I. As mobilising consumer motivation to switch may be costly, the benefits of such a strategy should be judged in advance. These benefits will be greater in markets for which a substantial public interest exists, such as health care.

Lesson III

Social capital, trust and reputation deserve more attention of economic policymakers. In some cases market imperfections can be partly overcome by relying on trust, social capital or reputation, next to or instead of relying on price incentives. Governments have an active role in trying to foster such implicit mechanisms.

Policymakers up till now assumed that external effects could be best internalised by taxes, subsidies and the like. The papers in this issue suggest that there is some potential to rely more heavily on a basic willingness to internalise external effects. This potential however, should be both well assessed and reinforced.

The potential for voluntarily internalising effects may differ with the cost of internalising them or with the type of effect. Potters shows that although some people always free ride on others, many people have a basic willingness to incorporate external effects to some extent, but in particular if others do as well. The willingness to internalise positive external effects appears to be greater than the readiness to

internalise negative effects. Similar notions with respect to negative externalities come from Graafland. He finds that as it comes to willingness to pay for sustainably produced goods, few consumers are willing to actually contribute.

Graafland shows that reputation may be helpful in disciplining firms with a bad sustainability record. He also notes however, that consumers' memory of a bad reputation is short lived and that Dutch consumers in general are quite brand loyal. Defective supplier behaviour is only punished after repeated treachery¹.

These studies seem to suggest that there is scope to rely on social capital to some degree, but that it should be supported by active policies to foster it.

For buying goods or services, empirical sociological studies find that for complex transactions, buyers often rely on trust and closed networks (friends, families, familiar suppliers). For goods and services where the qualities and contingencies of contractual delivery only are revealed over time, investing in durable relations is a strategy undertaken by suppliers and consumers to reduce uncertainty and lack of information. Stability is preferred to switching. When asymmetric information about the quality of a good or service prevails, agents may be better off in paying a 'good price' (possibly comparable to the economic notion of 'gift giving' (or gift giving in contractual relations see, e.g., Carmichael and MacLeod (1996)) to reduce uncertainty about the quality of the contracted performance, than in paying the lowest price.

For economic policymakers the lesson to learn is that in these cases there is more scope for leaving outcomes to the market and to implicit contract mechanisms.

The need to reinforce social capital will in general be smaller in societies where social capital is already strong. What matters is to get an impression of individuals' willingness to pay, versus their individual costs of internalising external effects². In societies with stronger social capital both the willingness to pay may be higher and the individual costs of internalising effects may be smaller since others also contribute. However, the higher the individual costs of internalising, the more weight might have to be given to legal backing of implicit arrangements and to traditional imperative interventions by means of subsidies or taxes. The lower the individual costs of internalising, the more it may suffice to enhance willingness.

Where fostering trust and reputation in contractual relations is concerned, the presented papers suggest ways through which this can be

done. For instance, to attain a long run perspective in which reputation mechanisms gain potential, Graafland advocates that in corporate governance stakeholders with a long run perspective be given more voice. Poiesz suggests that long term relations should not too easily be perceived as expression of lack of competition³. In fine tuning competition regulation this may be given a place. To allow for such fine tuning, competition authorities might greatly benefit from the flexible powers that are advocated by Lavrijssen et al. Flexible powers imply that these authorities should be given clear guidance as to their goals, but that their powers to help realise that goal can be adjusted to developments in the market. In transitory markets such powers should enable a wait and see strategy to see how the objectives of fostering efficiency can be best served.

Lesson IV

Economic policymakers expect that competition is enhanced by simply increasing the number of suppliers. However, more competitors do not automatically increase buyers' power or the perceived competitive pressure. Also, relevant markets may in practice be geographically confined. Policies to raise the number of competitors therefore do not necessarily have the expected beneficial effects.

The papers in this special issue suggest that it is too simple to expect that more competition and more suppliers always have beneficial effects. Poiesz points out that in the face of rising competition, the limitations of consumer ability to distinguish firm and product differences, may reduce the firm's expected benefits of diverging or improving its products. This notion, which has a parallel with economic theories on the benefits of so-called 'escape competition', may result in reduced incentives for product or process innovations. Graafland shows that the probability of being named and shamed after bad service declines with the number of suppliers, rendering 'perfect competition' suboptimal from the viewpoint of consumer discipline. Both studies may imply that in the face of growing competition, the influence of buyers may actually become *less* pressing.

As it comes to the downward pressure on prices that is expected from enlarging the number of competitors, Potters shows that the optimal number of suppliers is possibly limited. He suggests that prices may decline up to a number of four competitors and will not further

decline after the introduction of more suppliers. This may be partly due to a trade-off between downward price pressure of competition and reduced economies of scale. In psychology however, we may find alternative explanations for these findings. Just as for consumers, the ability of suppliers to interpret relevant influences and oversee the number of relevant competitors may be limited⁴, suggesting that a growing number of competitors may not automatically enhance the *perceived* competition. This may limit the competitive pressure that suppliers feel.

In terms of market regulation, these ideas raise interesting questions. In many areas the policy stance is to allow for increased competition by abolishing exclusive domain rights or by enlarging the relevant market. For instance, professional limitations are eased by allowing mouth hygienists to partly fulfil dentists' work, geographical domain limitations for e.g. health insurance providers and electricity distributors are abolished and exclusive provision rights for postal deliveries < 100 grams will be abolished. The contributions in this issue suggest that these domain enlargements will not automatically lead to better performance or to lower and more uniform prices. We do not think that this implies that easing access itself loses value. The role of policy may rather be in providing additional information. By helping both consumers *and* firms to compare qualities and prices, structural gaps in the knowledge of (relevant) suppliers may be bridged and the limitations in perceived competition may be partly overcome.

Even if the total number of suppliers is large, the market for goods or services may be actually geographically constrained. This is conceivable for instance in the markets for professional services like notaries. In such cases the additional benefits of enhancing knowledge about competitors may be limited. The benefits of the provision of information should be weighed against the danger that Potters points on: that raising transparency by having prices posted e.g., increases the scope for tacit collusion (proof of this is found in: J.D.W.E. Mulder and Baarsma B. (2004). Apparently the information need should be defined more specifically. In markets where services are footloose (like insurance) or the relevant market is big, information about number and prices/qualities of competitors may prove helpful. In geographically confined markets the contribution of such information is limited or possibly counterproductive. Weighing these elements may be helpful for instance in the case for allowing price posting in the professional services, which is currently under review.

Finally the contributions suggest that we may have to reconsider the benefits of choice relative to economies of scale. If effective buyer power is small and perceived competition also, the costs of reducing economies of scale may only be partly outweighed by the benefits of choice and competition. Further research is needed which explicitly focuses on perceived buying and competitive power, in relation to geography and economies of scale.

Lesson V

Economic policymakers expect that competition raises static and dynamic efficiency and as such maximises welfare. Given the four policy lessons discussed above, the outcome from increasing competition and choice may differ, but may still be optimal.

It was not only the belief that diversifying wants justify a policy aimed at increasing choice. Underlying the Lisbon agenda to make Europe's economy the most innovative and knowledge-intensive was the belief that choice and competition were the best means to get us there. This belief was based on the idea that markets can perform if the incentives are put in the right places. If consumers are given the tools to choose between firms, and under the restriction that they are rational and maximise utility, suppliers will be made aware of competitive pressure. To assure themselves of a stable or growing market share, they will be pressed to either differentiate their products to satisfy diverse consumer wants or to reduce costs. Product and process innovations are means to do so. Competition thus indirectly enhances innovation. And as innovation is crucial to growth, competition can be expected to raise the social surplus. Therefore, an important goal of allowing for choice is strengthening economic growth.

From the contributions presented here it appears that these outcomes do not necessarily result from market reform, nor that they necessarily represent the optimum. Instead of a short-term utility or profit maximising view, economic actors may take a long run perspective of investing in trust as a way of minimising cost. A strategy of non-switching may be the outcome. Such a strategy may not automatically lead to a level of innovation that corresponds to the ambitions of policymakers. Yet it may be an optimal outcome if information costs and motivation are incorporated in determining the optimum.

Also, people may have preferences for solidarity and for enhancing social capital, that are not automatically conducive to growth, as Arts shows, but may still be optimal from a broader perspective on welfare⁵.

Economic policy makers tend to view the causes for lower GDP per capita in Europe as compared to the US in too limited flexibility and competition in European economies. Possibly however, the main cause of the difference lies in preferences. It may, indeed, be the outcome of choice rather than the consequence of a lack of choice.

IV. CONCLUSION

In this article we have seen that there is a need for fine tuning regulatory policies on the abilities and wants of citizens. These seem to differ both with market types and with the role social capital, trust and reputation can play. If policymakers want to optimise welfare, both the ways to reach it and the elements that constitute the social optimum may have to be rethought. Economic theory itself is gradually incorporating lessons from other sciences in its concepts of rational and optimising behaviour. Switching costs, enforcement equilibria for external effects and the importance of social capital all are to some extent integrated in economic science. Implementing these integrated lessons in market regulation is of great importance. All the more since, if trends do not deceive, a further shift from public to private arrangements will be visible in the years to come.

This issue, we hope, has been an important contribution to doing so.

NOTES

1. Here we see a parallel with e.g. findings of Axelrod (1984) that in principal agent relations agents do not always follow a 'tit-for-that' strategy, but a strategy of 'a tit for two tats', in other words: agents punish only after repeated defectiveness.
2. On the power of reputation mechanisms to overcome external effects, see also Gelauff (2001).
3. See for instance R. Cooter, Do good laws make good citizens? An economic analysis of internalising legal values, Berkely Olin Program in Law and Economics working paper series, paper 38, 2000. <http://repositories.cdlib.org/blewp/>
4. In a special on information goods, developed for the ministry of economic affairs in 2001, we find similar ideas. See Y. Hiemstra, (2001).
5. In a study by EIM and Van Witteloostuijn, made for the ministry of economic affairs, these principles are illustrated and used to develop a competition perception index.

6. On the importance and the role of social capital a special issue has appeared in cooperation with the ministry of economic affairs: See ESB-Dossier (2003).

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